

# Quiet Counsel

Summer 2016  
Investment Outlook



 **Leith Wheeler**  
INVESTMENT COUNSEL LTD.

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## The Negative Interest Rate Experiment

### What are negative interest rates and why are we hearing of it?

Following the global financial crisis in 2008, central banks around the world responded with unprecedented monetary policy measures to offset weak economic growth and deflationary forces.

Monetary policy is the process by which the central bank of a country (i.e. its monetary authority) controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.

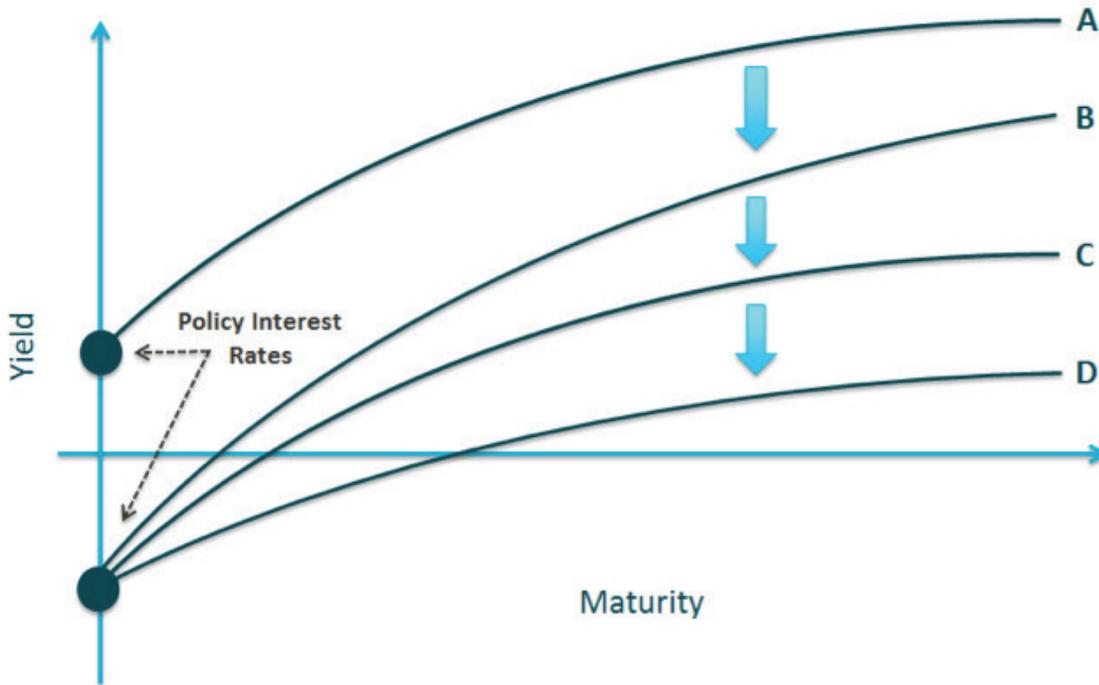
The normal shape of an interest rate yield curve can be seen below (exhibit 1; line A) where borrowing costs are always positive and increase with time. Measures taken in some countries recently have seen central banks:

- Lowering policy interest rates into negative territory (line B) which has a significant effect on short term interest rates but much less on longer dated yields;
- Providing forward guidance to the market that interest rates will remain low for longer (line C) which moderately lowers yields across the curve; and
- In some cases, outright purchasing of longer-dated bonds (line D) pushing prices higher and yields even lower across the curve.



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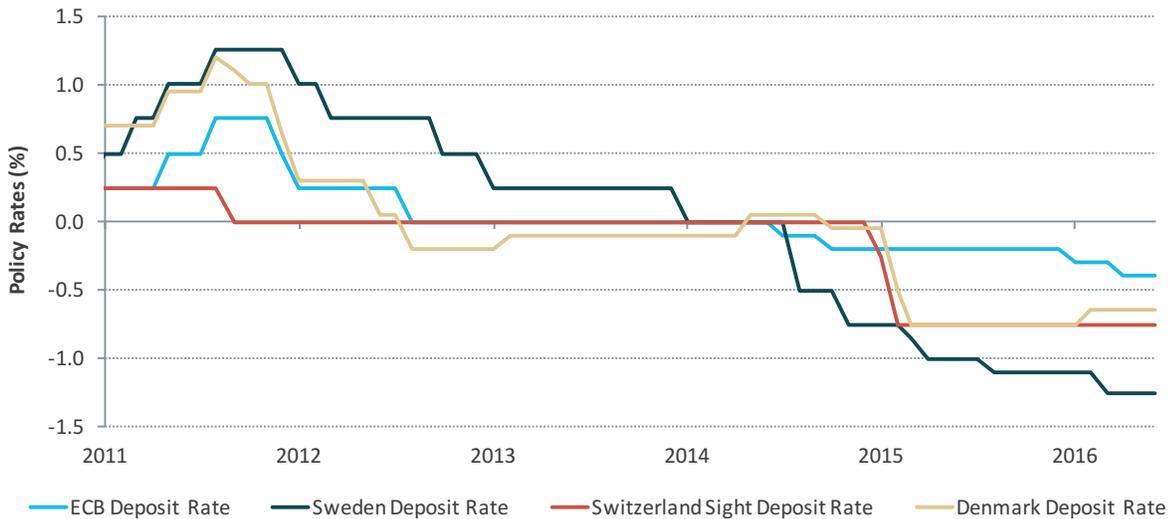
### Exhibit 1. Term Structures for Negative Yields



Negative policy rates are not entirely new. For example, in 1972, Switzerland introduced a negative rate charge on deposits by non-residents and Sweden briefly flirted with negative policy rates in 2012.

Today, negative policy rates are being targeted in the European Monetary Union, Switzerland, Sweden, Denmark, Hungary and Japan.

### Exhibit 2. Policy Rates



Source: Bloomberg

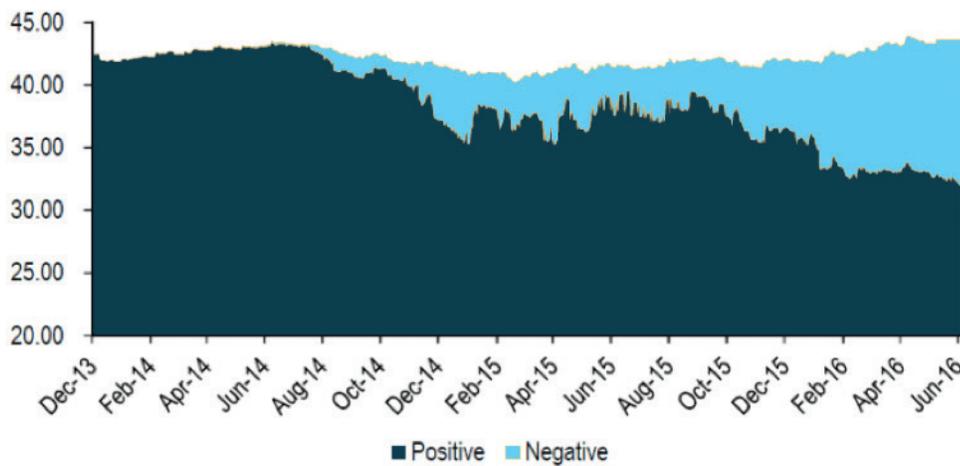
Negative policy rates work as a charge which central banks apply to excess reserves that commercial banks hold on deposit with their central bank. It should be known that commercial banks, to date, have not lowered interest rates on retail depositors below zero but there are banks, in some countries, including Switzerland, who have contemplated charging negative interest rates on some corporate deposit accounts. Charging negative interest rates on depositors is risky as it could result in depositors withdrawing their cash and triggering a run on the bank.

So why experiment with negative interest rates when the risks are both high and not entirely understood? For several countries, their ability to use government

spending as a tool to stimulate growth is limited by their already high indebtedness, and with short term interest rates already near zero, a negative interest rate policy and bond purchase program is simply their next best option. However, to be successful, commercial banks must lend their excess reserves to corporations who in turn will invest in people and capital goods to expand their businesses while individuals use funds to invest and consume, all of which stimulate economic growth.

Due to a combination of central banks targeting negative policy rates and alongside the purchase of government bonds, the effect has been to push a significant share – approximately 25 percent – of global bond yields below zero.

### Exhibit 3. Global Fixed Income Debt (in USD trillions)



Source: GFIM bond index.

Negative “real” yields (market yields less inflation) have occurred in a number of countries before;

however, it is negative “nominal” yields (real yields plus inflation) that are a relatively new phenomenon.

## Why buy bonds with negative yields?

1. Credit worthy bond issuers can be a safe haven when return **of** capital vs. return **on** capital is the primary concern;
2. If an investor predicted lower interest rates in the future than what the market indicated, investment in negative yield bonds could result in capital gains as rates fall further and prices rise;
3. Some investors, like pension plans and banks, are required to own bonds and do so in large quantities.

As long as employment and economic conditions remain unsatisfactory and inflation stable, central banks can continue using this means of monetary policy as a tool. It is impossible to predict the duration of such activity but we feel this will be measured in years, not months. The real test will be the magnitude and timing of the response, because in isolation, negative policy interest rates and bond purchases can only have limited effect.

## Is Canada headed for negative interest rates?

With the Government of Canada 10-year bond yield down to just over 1%, an anemic economic short term outlook and a 66% chance the Bank of Canada will ease interest rates in the second half of 2016, one might ask if we too are headed for negative interest rates. We cannot say this is impossible but the Bank of Canada Governor, Stephen Poloz, feels our situation is not nearly dire enough to contemplate such activity. Furthermore, our largest trading partner (the U.S.) is performing better economically, has higher yields and is indicating rate increases in the short term, which will limit Canada's ability to use loose monetary policy as a means of economic stimulation. Although we feel lower rates in Canada may occur in the short term, we also believe there will be a recovery in both Canada's policy interest rates and bond yields over our three year forecast period, partly due to a Canadian economy that will continue to recover, albeit at an anemic level, and partly due to the effect U.S. interest rates have on ours.

This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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